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**Tax Accounting Problems of Trustees**

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The two preceding issues of the *Marquette Law Review* have included discussions of the non-tax problems of Probate Accounting and *Trust Accounting* and the Tax Accounting Problems of Personal Representatives. This article will deal with tax problems of trustees and will emphasize the similarities and differences when compared to the non-tax accounting problems taken up in *Trust Accounting*. General income tax filing requirements and the taxability or non-taxability of trusts will be discussed, but any detailed discussion of how to fill out the Federal Form 1041 or the Wisconsin Form 2 is beyond the scope of this article.

### Federal Income Tax Law

#### I. General Filing Requirements and Taxability of Trusts.

A Form 1041 must be filed by the trustee for the trust when the trust has any taxable income, or when it has gross income of $600 or more, regardless of the amount of taxable income, or when any beneficiary of the trust is a nonresident alien. Except where all the trust income of a taxable year must be distributed in that year, trusts claiming charitable deductions under Code Section 642(c) must, in addition, file Form 1041-A. In the case of joint fiduciaries, the return must be executed by one of them. The fiduciary so executing in any case must declare (1) that he has sufficient knowledge of the affairs of the estate or trust to enable him to make the return, and (2) that the return is to the best of his knowledge and belief true and correct.

Returns by a trustee on behalf of a trust, taxable or non-taxable, for which he acts are due on or before the 15th day of the fourth month following the close of the taxable year of the trust, and should be filed with the District Director of the district where the trustee resides or has his principal place of business.

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4 See *Trust Accounting* supra note 2.

5 INT. REV. CODE OF 1954, §641(b); Treas. Reg. §1.641(b)-2.

6 INT. REV. CODE OF 1954, §6012(a).

7 INT. REV. CODE OF 1954, §6012(b) (5).

8 INT. REV. CODE OF 1954, §6072(a).

9 INT. REV. CODE OF 1954, §6091(a).
A trustee, like any other taxpayer, must elect in its first return whether it will account for the trust income on a calendar or a fiscal year, and whether on a cash or accrual basis. The short taxable year is applicable to a trust’s first return where the fiduciary elects a taxable period which begins less than 12 months from the date of the inception of the trust, and also for the trust’s final return when the trust terminates less than 12 months from the beginning of its taxable year. Unlike individuals, estates and corporations, the fiduciary of a trust cannot pay the income tax due in installments, and the tax must be paid in full when the return is filed. Extensions of time for filing the trust return may be granted, but this does not carry with it the right to postpone payment of the tax unless it is shown to the Commissioner’s satisfaction that such payment would result in undue hardship to the trust.

It must be pointed out that not all trusts are taxable entities. A “substantial owner trust” is a separate entity having independent legal significance for purposes of trust law, but for Federal income tax purposes, it is not a separate taxable entity. Fiduciary income tax returns should be filed, but the portion of trust income taxable to the grantor of a trust or to another person as substantial owner is not reported on the Form 1041. Such income and applicable deductions and credits are shown on a separate statement attached to the form. Income, applicable deductions and credits are set forth on the form itself only where and only to the extent that the trust is a separate taxable entity for Federal income tax purposes. To the extent that a grantor or other person is substantial owner of the trust, the income, deductions and credits against tax of the trust are reported on his own individual return in the same manner and to the same extent that they would be reportable if no trust existed. Before filling out a fiduciary return one must, therefore, determine whether or not the trust in question is a substantial owner trust, in whole or in part.

There are five reasons why the income of a trust may be attributable to the grantor and the grantor treated as the owner of the entire trust or a part of it: (1) a retained power to revoke, (2) a retained right to income, (3) a retained reversionary interest, (4) a power to control beneficial enjoyment, or (5) a retained administrative power.

A person other than a grantor may also be treated as the substantial owner of a trust where he has a power to vest the entire corpus, or the

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10 Int. Rev. Code of 1954, §§441 (b) (3) and 443 (a) (2).
13 1962 Instructions for Form 1041, p. 2, 90.
income, in himself. For example, where a decedent's will creates two testamentary trusts; a marital trust giving the widow income for life and a right to withdraw any part or all of the trust corpus, and a residuary trust giving the widow income for life but no power to withdraw, two Forms 1041 are filed. The return for the marital trust in this case is simply an information return. The trust income, deductions and credits are not listed on the return itself, but on the separate statement attached. The widow treats the various items in her own personal return in the same way and to the same extent that she would if no trust existed. The return for the residuary trust is a return for a separate taxable entity.

Trusts which are treated as separate taxable entities are divided into two basic categories, simple and complex. A trust is a simple trust during its taxable year if (a) its terms require that all of its income be distributed currently (b) no amounts other than income required to be distributed currently are distributed to a beneficiary, that is, no principal payments are made during the year, and (c) no amounts are paid or accumulated for charitable purposes. All trusts failing to meet these three requirements are complex trusts.

Any trust which is required to distribute all of its income currently is allowed an exemption of $300. Not only are all simple trusts allowed the $300 exemption, but, in addition, a trust required to distribute all income currently, with a portion going to charity may take the $300 exemption even though it is not a simple trust. Similarly, where the instrument requires that all of the income be distributed currently to a beneficiary, payments of principal during the year change the trust from a simple to a complex trust for such year, but the $300 exemption is allowable. That is, to ascertain the appropriate exemption it is only necessary to determine whether or not the trust is one which is required to distribute all of its income currently. If so, the exemption is $300, but if not, the exemption is only $100 for any trust which accumulates income other than capital gains.

II. **Tax Treatment of Income and Expense Items.**

The gross income of a trust is determined in the same manner as that of an individual. In many instances, the treatment of income and expense items for tax purposes differs substantially from the treatment of these same items for non-tax accounting purposes, as discussed in *Trust Accounting*. As a result, in addition to the trust accounting records kept for non-tax purposes, separate records must be kept for tax accounting purposes.

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20 INT. REV. CODE OF 1954, §651; Treas. Reg. §1.651(a).
21 INT. REV. CODE OF 1954, §642(b); Treas. Reg. §1.642(b)-1.
22 INT. REV. CODE OF 1954, §641(a); Treas. Reg. §1.641(a)-2.
23 See *Trust Accounting, supra* note 2.
A. Corporate Distributions

1. Stock Dividends.

The Uniform Principal and Income Act as adopted in Wisconsin allocates "all dividends on shares of a corporation forming a part of the principal which are payable in the shares of the corporation" to principal. Wisconsin has not yet adopted the Revised Uniform Principal and Income Act §§6(b) and (d) which would allocate to income certain stock dividends declared in connection with a corporate reorganization such as a preferred stock dividend paid in discharge of preference dividends in arrears. This allocation of all stock dividends to principal by the Uniform Act as adopted in Wisconsin is different from the treatment for tax purposes. Although for tax purposes generally a stock dividend is not included in gross income, it is included in gross income to the extent paid in discharge of preference dividends for the distributing corporation's current or preceding tax year.

When a stock dividend is non-taxable, the determination of the tax basis for the new and the old shares is made in the same manner as is the valuation of the new and old shares in the principal account for non-tax accounting purposes, i.e., the dollar value of each share is quotient of the adjusted basis of the old shares divided by the total number of old and new shares. But if the stock dividend is taxable, the old stock retains its original basis. The new stock is included in gross income at its fair market value when received, and that becomes its basis.

2. Stock Rights.

The distribution of stock rights to a trust is allocable to principal for non-tax accounting purposes, as are the proceeds from any sale of these rights. But for tax purposes the rights may be taxable or non-taxable, the same test being applied as in the case of stock dividends. Thus, rights are not included in gross income unless (1) paid in discharge of preference dividends, or (2) the shareholder has the option to take money or other property.

On the non-tax accounting records the only entries made upon the exercise of stock rights are to increase the number of shares by the number of new shares, and to increase the dollar amount assigned to the particular stock by the amount paid for the new shares with a corresponding decrease in principal cash. The tax accounting records will differ, not only for taxable rights but also for non-taxable rights.

24 Wis. Stat. §231.40(5)(a) (1961); Uniform Principal and Income Act §5(1).
26 Int. Rev. Code of 1954, §305(b); Stock dividends are also included in gross income if the shareholder had the option of taking either the stock or other property.
27 Wis. Stat. §231.40(5)(b) (1961); Uniform Principal and Income Act §5(2); The Revised Uniform Principal and Income Act §6(a) has a similar rule.
If the market value of a non-taxable right is less than 15% of the market value of the stock on which the right was distributed, the basis of the right is zero, unless the taxpayer elects to determine the basis by a method of allocation. If the value of the right is 15% or more of the value of the stock, a basis for the right must be computed by making an allocation. Allocation means that a basis for the right is computed by allocating to the right a portion of the basis of the stock upon which the right was issued. The allocation is made according to market values of the stock and right. Market values on date of distribution of the rights (not record date) are used.

Taxable stock rights give rise to income only when exercised or sold. Mere receipt of such rights does not result in income, and no loss is allowed if taxable rights are received and permitted to expire without exercise or sale. Where the rights are exercised the amount reportable as income is the excess of the fair market value of the new stock received over the subscription price. The cost basis of the new shares is the amount reportable as income plus the subscription price. The date basis of the new share is the date the rights were exercised. The cost basis and date basis of the old shares remain unchanged. Where the taxable rights are sold, the amount reportable as income is the amount received upon the sale.

3. Cash Dividends.

All dividends in cash are allocated to income under the Uniform Principal and Income Act. The treatment of cash dividends for tax purposes is not nearly so simple. Generally, such distributions are in-

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32 1947-1 Cum. Bull. 45; St. Louis Trust Co., 30 B.T.A. 370 (1934). However, if a taxpayer purchases rights for a valuable consideration and allows them to expire without exercise or sale, a deductible loss is allowed. Mitchell, 48 F. 2d 697, 9 A.F.T.R. 1181 (2d Cir. 1931).
33 1947-1 Cum. Bull. 45. The Court of Appeals for the Second Circuit has held that the amount reportable as income is the excess of the fair market value of the new stock received over the subscription price at the time the rights are issued, or such excess when the rights are exercised, whichever is lower. Chaote v. Comm., 129 F. 2d 684, 29 A.F.T.R. 965 (2d Cir. 1942).
34 The excess of the fair market value of the new stock received over the subscription price is sometimes referred to as the "spread" between the value of the new stock and the price paid therefor. This amount ordinarily determines the fair market value of the rights. Thus, a quick way of determining the amount of income to report is to obtain a market quotation for the rights.
35 Wis. Stat. §231.40(3) (a) (1961); Uniform Principal and Income Act §(3) (1). The same rule is adopted by the Revised Uniform Principal and Income Act §6 (d).
come to the trust and must be included in its gross income. There are, however, a number of statutory exceptions to this rule.

Of primary importance among these exceptions is the dividend exclusion. In determining the amount of the trust's dividend exclusion, the Internal Revenue Service in its instructions for Form 1041 requires the trustee to prorate the dividend exclusion where some of the dividends are distributed to the beneficiary. Coupled with the dividend exclusion is the dividends received credit. Like the dividend exclusion, the dividends received credit of a trust is to be based only on dividends which are not properly allocable to beneficiaries. To the extent that dividends are properly allocable to beneficiaries, the beneficiaries, and not the trust, are entitled to the credit for dividends received.

With a simple trust all of the ordinary income is currently distributable, and there is no occasion to compute the trustee's portion of the dividend exclusion, and the trustee's share of the dividend credit. Ordinarily all of the dividend income of a simple trust passes through the trust as through a conduit to the income beneficiary to be reported by the beneficiary in his own return. There is an exception to this rule in the case of a simple trust receiving taxable stock dividends which are allocated to principal and not paid to a beneficiary. If the exception applies the dividend credit should be computed.

Many corporations distribute dividends which are partially or wholly non-taxable because of the source from which they are paid. In order to be taxable to the stockholder as an ordinary dividend, the distribution must be made (1) out of earnings or profits of the taxable year or (2) from earnings or profits accumulated after February 28, 1913. One reason why a corporation's dividends are partially or wholly non-taxable would be that for tax purposes it uses accelerated depreciation of its assets, but for dividend purposes it uses the straight-line method and can therefore, under local law, distribute earnings in excess of the earnings the corporation reports for tax purposes. The non-tax accounting records kept by the trustee are not sufficient for tax purposes in regard to the basis for the stock in such corporations because, for tax purposes, the adjusted basis of the stock must be reduced by the portion of the dividend that is non-taxable, whereas on the non-tax accounting records all of the dividend was allocated to income.

37 1962 Instructions for Form 1041, p. 3, ¶1.
38 INT. REV. CODE OF 1954, §34.
39 Treas. Reg. §1.642(a) (3)-1.
40 As mentioned previously, those taxable stock dividends paid in discharge of preference dividends in arrears are allocated to principal in Wisconsin. Another type of taxable stock dividend, where the trust has the option to take money or other property, which will be discussed later is allocated to income so that this exception would not apply.
41 1962 Instructions for Form 1041, p. 2.
42 INT. REV. CODE OF 1954, §316(a); Treas. Reg. §1.316-1.
4. "Cash or Stock" Option Dividends.

Where the trustee has an option of receiving a dividend in cash or in the stock of the declaring corporation, the dividend is allocated to income, irrespective of the trustee's choice. This treatment is the same as the tax accounting treatment for these taxable dividends under Section 305 of the 1954 Internal Revenue Code.

5. Dividends in Kind.

Dividends in kind are allocated to income under the Uniform Principal and Income Act in Wisconsin. For tax accounting purposes, to determine whether the dividend is included in gross income in whole or in part and whether or not the adjusted basis of the declaring corporation's stock is affected, the trustee must look to the source from which the distribution is made, just as he must in the case of cash dividends.

Wisconsin adopted an exception to the above-mentioned rule, presumably to cover situations where a corporation must divest itself of shares in another corporation because of governmental anti-trust action:

[A]ny distribution of shares or other securities or obligations of corporations other than the distributing corporation, or the proceeds of sale or other disposition thereof, made as a result of a court decree or final administrative order by a governmental agency heretofore or hereafter entered ordering the distributing corporation to divest itself of the shares, securities or other obligations shall be deemed principal unless the distributing corporation indicates that the distribution is wholly or partly in lieu of an ordinary cash dividend in which case the distribution to the extent that it is in lieu of the ordinary cash dividend shall be deemed income.

Following a recent divestiture of this type, pursuant to a 1961 judgment of the U.S. Supreme Court, Congress passed a law permitting treatment of the distributed stock as a return of capital by the distributing corporation's noncorporate shareholders. A noncorporate shareholder would use the fair market value on date of distribution of the stock received to reduce the basis of his stock in the distributing corporation. The excess, if any, of the market value of the stock received,
valued as of the date of distribution, over the basis of the distributing corporation’s stock, would be taxed as a capital gain.


Any distribution by a mutual fund or investment company designated by it as a capital gains dividend shall be treated as principal in Wisconsin.49 For tax purposes, capital gains dividends paid by regulated investment companies50 are taxed to the recipient trusts as long-term capital gain so that only 50% of the dividend is included in taxable income regardless of the period for which the trust held the stock.51 No adjustment of the basis of the stock is to be made as a result of the receipt of a capital gain dividend.

In addition to the capital gains distributed, there will often be undistributed capital gains by regulated investment companies. The company will pay the appropriate tax on such retained long-term capital gains.52 The trust-stockholder will be required to report its proportionate share of such retained long-term capital gains,53 but may obtain a credit for the tax paid by the company.54 For non-tax accounting purposes no adjustment is made for the shares in the regulated investment company held by the trust, but, for tax accounting purposes, the adjusted basis of such shares must be increased by 75% of the amounts required to be included in computing the trust’s long-term capital gains as a result of the undistributed capital gains.55

7. Liquidating Dividends.

Corporate distributions labeled by the corporation as liquidating dividends are allocated to principal, as a return of the trust’s investment, under the Uniform Principal and Income Act as adopted in Wisconsin.56 For tax purposes, distributions in liquidation are treated, in effect, as a sale of stock.57 The gain or loss upon receipt of a liquidating dividend is a short-term or long-term capital gain or loss, depending upon the length of time the stock has been held.58 But if the liquidation

49 Wis. Stat. §231.40(5)(a) (1961); The Revised Uniform Principal and Income Act §6(c) follows the rule of allocation to principal.
56 Wis. Stat. §§231.40(3)(b), (5)(c) (1961); Uniform Principal and Income Act §83(2), 5 (3). The first named section allocates proceeds from the liquidation of other trust property to principal.
57 Int. Rev. Code of 1954, §331(a); Treas. Reg. §1.331-1.
58 As a general rule, in the case of liquidating dividends distributed in installments, the stockholder is not required to report income until he has recovered the cost or other basis of his stock. O.D. 343, 1 Cum. Bull. 80; O.D. 461, 2 Cum. Bull. 85; Ludorf, 40 B.T.A. 32 (1939). If stockholders, having received distributions in complete liquidation, subsequently pay their liability as transferees for tax deficiencies of the corporation, losses sustained by the stockholders through payment of such deficiencies are capital losses, not ordinary losses. Arrowsmith v. Comm., 344 U.S. 6, 42 A.F.T.R. 649 (1952).
is followed or preceded by a transfer to another corporation of all or part of the liquidating corporation's assets, the liquidating distribution may be treated as an ordinary dividend (taxable as ordinary income) or as a transaction in which no loss is recognized and gain is recognized only to the extent of other property received. Under certain conditions, gain on the liquidation of a "collapsible corporation" is treated as ordinary income instead of capital gain.

B. PREMIUM AND DISCOUNT BONDS

1. Premium Bonds.

The Uniform Principal and Income Act as proposed and adopted in Wisconsin reverses the common law requirement of amortization of bond premiums by establishing the bond as principal at its inventory value, or, if none, at market value or cost where purchased later, regardless of par or maturity and that upon maturity or sale, the gain or loss falls upon principal. But for tax accounting purposes amortization may be mandatory or optional, depending upon the type of bond.

In the case of wholly tax-exempt obligations, it is mandatory that the taxpayer amortize the premium. Since the interest received is wholly exempt, no deduction is allowed for the amount of amortization. The basis, however, must be reduced by the amount of the amortization.

In the case of partially tax-exempt obligations and wholly taxable obligations, the trustee may elect to amortize and deduct the bond premium. The amount of any amortization deduction taken reduces the adjusted basis of the bonds.

2. Discount Bonds.

The Uniform Act, in order to reduce the trustee's non-tax bookkeeping, prohibits increasing income payments where bonds are purchased at a discount. An exception is made in Wisconsin in the case of bonds issued at a discount and "subject to a definite appreciation in value on a fixed schedule" in that the increment shall be allocated to income on each date that the increment occurs.

For tax accounting purposes, the amount of the discount is normally included in income in the year of sale or other disposition. Nor do the

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59 INT. REV. CODE OF 1954, §331; Treas. Reg. §1.331-1(c).
60 INT. REV. CODE OF 1954, §341; Treas. Reg. §1.341.
61 WIS. STAT. §231.40(b) (1961); UNIFORM PRINCIPAL AND INCOME ACT §6; THE REVISED UNIFORM PRINCIPAL AND INCOME ACT §7 does not change this rule.
63 INT. REV. CODE OF 1954, §1016(a) (5); Treas. Reg. §1.1016-5(b).
64 Note 62 supra.
65 Note 63 supra.
67 WIS. STAT. §231.40(b) (1961); UNIFORM PRINCIPAL AND INCOME ACT §6.
68 WIS. STAT. §231.40(b) (1957).
69 INT. REV. CODE OF 1954, §1232.
tax laws agree with the non-tax accounting treatment Wisconsin provides for the discount bonds which are subject to definite increments in value at fixed dates. Bonds of this type are U.S. Savings Bonds, Series "E," and "Growth Savings Certificates." The trustee may treat the taxable increment on Series "E" bonds as income received in the year of redemption or maturity, or he may elect in the return to report the taxable increment for each year as income for that year.70 "Growth Savings Certificates" are also covered by this election under a 1957 ruling.71

C. Natural Resources and Wasting Assets

1. Natural Resources.

When part of a trust's corpus consists of property from which timber, mineral, oil, gas or other natural resources may be taken, the proceeds received on a lease shall be income, but if received as royalties for the permanent severance of the natural resources from the land they are principal for non-tax accounting purposes.72

Although frequently criticized, the Internal Revenue Code provisions seem more equitable and realistic than the Uniform Principal and Income Act rule.73 For tax accounting purposes the trustee reports the gross receipts as income to the trust, but the trust is allowed a deduction for depletion and depreciation.74 This deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the income allocable to each, unless the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.75 Under both the Uniform Act and the Wisconsin version there is no provision for a depreciation or a depletion reserve, which is in direct conflict with both accounting and tax practice. The tax law theory is that the annual deduction for depletion and depreciation, in the aggregate, will return the cost or other basis of the property plus subsequent allowable capital additions.76 Each year the "cost basis" of the property is reduced, but not below zero, by the amount of depletion deducted for that year, regardless of what method of depletion is used.77 Thus it can be seen that

73 Several states have amended the Uniform Act by setting aside a portion of receipts of royalties as depletion allowances and giving the rest to income. Tex. Rev. Civ. Stat. art. 7425 (b) 33 (1960); Okla. Stat. Ann. tit. 60, §175.33 (1949); Vt. Stats. Ann. tit. 14, §3309 (1958). The Revised Uniform Principal and Income Act §9 follows the Internal Revenue Code and allocates 27½% of gross receipts (but not over 50% of the net receipts) to principal as an allowance for depreciation. The balance after payment of expenses is income.
75 Int. Rev. Code of 1954, §167(h) ; 1954 Code §611(b) (3).
76 Treas. Reg. §1.611-1; Treas. Reg. §1.611-5.
77 In general, there are two methods of computing the depletion deduction; (1) the cost method, Int. Rev. Code of 1954, §612; and (2) the percentage method, Int. Rev. Code of 1954, §613, which ordinarily permits recovery of much more
separate cost records must be kept for natural resources and wasting assets for tax accounting purposes.

2. **Leaseholds, Patents, Copyrights and Royalty Rights.**

Since the Wisconsin legislature failed to make specific provision for leaseholds, patents, copyrights and royalty rights, the writer of *Trust Accounting* felt that this evinced a legislative intent not to disturb the common law. The prior Wisconsin view was that the general intent of settlors is to allocate the receipts from wasting assets in general to principal to be reinvested for the benefit of the income beneficiary.

For tax accounting purposes the receipts from these wasting assets are included in income, and deductions are allowed for depreciation, depletion, interest, taxes, etc. Generally, expenditures which add to the value or useful life of such property are not allowable as expense deductions. They are treated as permanent investments to be added to the cost basis of the property and charged off through depreciation.

**D. EXPENSES**

Under the Uniform Act as adopted in Wisconsin ordinary expenses such as taxes, water rates, insurance premiums, interest, compensation of assistants and agents are chargeable to income. Other expenses such as investment costs, court costs, attorney's fees, other fees on accountings and maintaining or defending actions to protect the trust, costs of and assessment for improvements to the property, and tax on gain or profit defined as principal are chargeable to principal. The expense of the trustee's commissions was changed in Wisconsin by charging 75% to income and 25% to principal irrespective of whether the fee is computed upon income or principal.

In general, a trust is allowed the same deductions for tax purposes for expenses incurred in carrying on a trade or business or in the production of income as an individual. Special rules govern certain deductions than cost. Even though the basis of depletable property is reduced by the amount of percentage depletion currently deductible, percentage depletion deductions will not be denied simply because the basis of the property has been reduced to zero. A taxpayer may recover a larger amount tax free through depletion than he could through a sale or other disposition of the property. It is this inequality of the tax law in favor of the oil interests that is often criticized.

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78 Note 2 supra, at 493.
79 Estate of Wells, 156 Wis. 294, 304, 144 N.W. 174, 177 (1913).
82 Wis. STAT. §231.40(8) (a) (1961); UNIFORM PRINCIPAL AND INCOME ACT §(8) (1). THE REVISED UNIFORM PRINCIPAL AND INCOME ACT §13(a) (1) is to the same effect.
83 Wis. STAT. §231.40(8) (b) (1961); UNIFORM PRINCIPAL AND INCOME ACT §8(2). THE REVISED UNIFORM PRINCIPAL AND INCOME ACT §13(a) (2) to the same effect.
84 Wis. STAT. §231.40(8) (c) (1961).
85 According to the fee schedule published in the Fall 1955 issue of Milwaukee Bar Association Gavel, p. 15, trustees' fees, except as to rental income, are computed as a percentage of the trust principal.
tions, such as those for depreciation and depletion, already discussed, and for charitable contributions. In addition to the usual deductions, however, a trust is allowed deductions for income distributed or distributable to beneficiaries, but, since the distribution deduction deserves special and detailed discussion, it will not be taken up in this article.

Expenses paid or incurred by a trust are deductible if they are: (1) ordinary and necessary expenses incurred in trade or business; (2) ordinary and necessary expenses paid or incurred for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income; (3) reasonable amounts paid or incurred by the trustee, including ordinary and necessary trustee's fees and litigation expenses in connection with the duties of administration (except expenses allocable to the production or collection of tax-exempt income); ordinary and necessary expenses paid or incurred in connection with the determination, collection, or refund of any tax. However, to the extent such expenses are allocable to the production or collection of tax-exempt income, they are not deductible.

Expenses incurred in defending or protecting the trust's title to property, or recovering such property, are not deductible. They are capital expenditures. Similarly, expenditures incurred in protecting or asserting the trust's rights to property of a decedent as legatee under a testamentary trust are nondeductible capital expenditures. An item which is nondeductible is not rendered deductible by the fact that property held by the trust will be sold to satisfy a claim, which property would otherwise be held for the production of income.

It is immaterial whether the expenses, if deductible, are paid from the principal or from the income of the trust. They derive their character not from the fund from which they are paid, but from the purposes for which they are incurred.

**Wisconsin Income Tax**

I. General Filing Requirements and Taxability of Trusts

The taxation of trusts in Wisconsin is much simpler than federal trust taxation, and as a result, a more complete explanation of it can be given in this article than was given for federal taxation where, for example, the intricacies of the deduction for distributions to beneficiaries was not delved into because it deserves special and detailed discussion.

Trustees in Wisconsin must annually make a return on Form 2 of all income received by them as such to the assessor of incomes of the
county in which the trust is being administered on the fifteenth day of the fourth month following the close of the calendar year, or, if the trust has a fiscal year, following the close of such fiscal year.

The net income is computed and reported as on an individual return, except that the personal exemptions allowed individuals shall not be allowed the trustee. Income of a trust that is not distributable is taxed to the trustee, except for the income permanently set aside to be used exclusively for the state, municipalities or other exempt organizations. There is a deduction from the trust’s income for amounts distributed or distributable according to the terms of the trust instrument or by order of the court. The return must show the names and addresses of all distributees, and the amounts distributable to them, whether distributed or not. Notice that even though all non-tax accounting income is required to be distributed, and the trust takes the deduction for such distributable income, there will still be taxable income to the trust if there are gains on the sale of property which are allocable to principal, as they are under the Uniform Act as adopted in Wisconsin, and the gains exceed any non-tax accounting principal deductions which are also tax deductions.

As pointed out earlier in this article, revocable trusts are not separate taxable entities for federal tax purposes. But, for Wisconsin income tax purposes, accumulated income of a revocable trust, while it is in effect is taxable. Another difference in the general tax pattern between Wisconsin law and federal law occurs when fixed annuity payments are required to be paid from a testamentary trust. These payments would normally qualify for the federal distributions deduction under the general rule, but for Wisconsin income tax purposes such payments are considered bequests from the deceased settlor, and therefore not deductible by the trust as distributable income. A third difference occurs upon termination of a trust. The trust is merely a conduit for the final taxable period for federal purposes, but, for Wisconsin tax purposes, the trust is a taxable entity until actual termination.

92 Wis. Stat. §71.10(2) (1961).
93 Wis. Stat. §71.09(6) (a), (b) and (c) (1961).
94 Note 91 infra.
95 Wis. Stat. §71.08(9) (1961).
96 Note 95 infra.
97 Note 91 supra.
98 Wis. Stat. §231.40(3) (b) (1961).
99 It has been held that payments not required to be made out of income and actually made out of principal are not deductible by the trustee. First National Bank of Berlin v. Wisconsin Department of Taxation, 1 W.B.T.A. 349 (1941).
100 Note 14 supra.
101 First Wisconsin Trust Co. v. Wisconsin Department of Taxation, 273 Wis. 135, 76 N.W. 2d 541 (1955).
103 Appeal of Van Dyke, 235 Wis. 128, 292 N.W. 313 (1940).
104 Treas. Reg. §1.641(b)-3.
105 Note 95 supra.
II. \textit{Tax Treatment of Income and Expense Items}

In the corresponding discussion under federal income tax law, the necessity of keeping federal tax accounting records in addition to the trustee's non-tax accounting records was pointed out. As will be seen from the following discussion, there is also a necessity to keep a third set of records for Wisconsin tax accounting purposes.

A. \textbf{Corporate Distributions}

The Wisconsin income tax statute as to gross income from dividends reads "all dividends." However, there are many exceptions which exclude from gross income certain dividends and corporate distributions.

1. \textbf{Stock Dividends and Stock Rights}

The basic tax rules for stock dividends and stock rights are the same for Wisconsin as they are for federal tax purposes. Distributions of true stock dividends and rights to acquire stock are not included in gross income as a general rule. There are exceptions as to stock dividends or rights issued in discharge of preference dividends, or where there is an election on the part of any stockholder to take stock or rights, or property.

2. \textbf{Cash, "Cash or Stock" Option Dividends, and Dividends in Kind}

Unlike federal tax law, Wisconsin has no dividend exclusion or dividend credit. However, Wisconsin does treat some dividends as being wholly or partially non-taxable if not made out of earnings and profits accumulated after January 1, 1911, or from the most recently accumulated earnings and profits. This is similar to the federal rule regarding the source of dividends and, similarly, the adjusted basis of the stock must be reduced by the portion of the dividend that is non-taxable, whereas on the non-tax accounting records all of the dividend was allocated to income.

"Cash or stock" option dividends are treated the same for Wisconsin tax purposes as they are for federal tax purposes in that they are included in gross income regardless which election the shareholder makes as to the type of dividend he wishes to receive.

Under Wisconsin tax law, as under federal tax law, a dividend in kind is generally included in gross income at the property's fair market value. In addition, the Wisconsin legislature recently followed

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106 Wis. Stat. §71.03(1) (d) (1961).
107 Notes 25, 26, 27, 29, and 31 supra.
110 Notes 36 and 37 supra.
111 Notes 38 and 39 supra.
113 Note 42 supra.
114 Notes 35, 43, and 44 supra.
115 Wis. Stat. §71.305(2) (b) (1961).
the federal government's lead in granting tax relief to recipients of stock divestitures. An exception to the general rule was made in that a distribution of divested stock, as defined in the Internal Revenue Code, shall not be included in gross income for tax purposes, but to the extent it exceeds the basis of the stock, it shall be treated as a gain from the sale or exchange of property. The valuation basis of property received pursuant to a stock divestiture order shall be the fair market value of the property as of the date of the distribution.

3. Capital Gains Dividends

The attractiveness of capital gains dividends, usually payable either in cash or stock at the shareholder's election, for Wisconsin tax purposes was greatly reduced in 1955 when the Wisconsin legislature passed the exception to the general rule of non-taxability of stock dividends. Prior to 1955, if a shareholder elected to receive a stock dividend it was not a taxable distribution, but now Wisconsin treats "cash or stock" option distributions as income, as it is treated for non-tax accounting purposes and for federal tax purposes.

In Wisconsin there is no provision made for taxation of the undistributed capital gains by regulated investment companies as there is under federal tax law. Thus we have here one of the many instances which will necessitate separate cost records for trust assets, i.e., for federal tax purposes the basis is adjusted for undistributed capital gains, whereas for Wisconsin tax purposes the basis is not adjusted.

4. Liquidating Dividends

The general rule in Wisconsin on liquidating dividends is that the distribution of money and property upon liquidation of a corporation shall be treated as in part or full payment of stock in the corporation. The general rules for taxability of distributions of property do not apply to liquidations in Wisconsin. This is in accord with the general treatment of liquidating dividends under federal tax law.

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118 Note 48 supra.
119 INT. REV. CODE OF 1954, §301(f)(1).
120 Chapter 17 amends Wis Stat. §71.301(3) and (4); approved April 16, 1963; effective as to any distributions occurring on or after January 1, 1962. The passage of this amendment came as a relief to many Wisconsin trustees because it eliminated the necessity of keeping separate cost records for federal tax basis purposes as to these particular stocks, and also because some Wisconsin trustees, anticipating the passage of the amendment, had not reported these distributions as dividend income on the 1962 Wisconsin fiduciary tax returns, which had been filed one day prior to the passage.
121 Chapter 571 was enacted in 1955 and created Wis Stat. §371.05.
122 Note 43 supra.
123 INT. REV. CODE OF 1954, §305.
124 Notes 52, 53, 54 and 55 supra.
125 Note 55 supra.
126 Wis Stat. §71.331 (1961).
127 Note 117 supra.
128 Note 57 supra.
B. PREMIUM AND DISCOUNT BONDS

For Wisconsin tax purposes, there is no distinction made as to the type of bond, as there is under federal law, for amortization treatment of the premium.\(^{129}\) Nor does Wisconsin tax law agree with the federal treatment of bond discount.\(^{130}\) In Wisconsin, if bonds are issued at a discount or premium, the net amount of such discount or premium must be amortized over the life of the bonds. If bonds are retired at a price in excess of or less than the issuing price, the profit or loss resulting is taxable income or deductible expense in the year in which such bonds are retired, provided proper adjustment is made for the discount or premium previously reflected in income.\(^{131}\) As a result of the differing treatment of premium and discount bonds for Wisconsin tax purposes, federal tax purposes and for non-tax trust accounting purposes\(^{132}\) separate basis records must be kept for these trust assets.

C. NATURAL RESOURCES AND WASTING ASSETS

1. Natural Resources

Royalties received as a result of investment in equities in oil, gas, and mineral properties outside Wisconsin are not taxable in Wisconsin, since income from such property follows the situs of the property from which derived.\(^{133}\) An equitable ownership in natural resources which, under leases, produces so-called royalties is equivalent to the ownership of the land and the royalties are, in effect, rent.\(^{134}\) It follows that there can be no depletion deduction taken nor should the cost basis of such property be adjusted as it is for federal tax purposes,\(^{135}\) thereby necessitating separate cost records.

Income received from oil, gas and mineral properties located in Wisconsin must be included in taxable income.\(^{136}\) As a result separate records must be kept because the allowable depletion rates\(^{137}\) are different from the federal rates,\(^{138}\) and after depletion of the income tax cost to the extent of 100% has been allowed, no further deduction is permissible\(^{139}\) as it is under federal tax law.\(^{140}\)

2. Leaseholds, Patents, Copyrights and Royalty Rights

Wisconsin taxation of rents from a leasehold is similar to taxation of royalties from natural resources, in that it depends upon whether or

\(^{129}\) Notes 62, 63, 64 and 65 supra.
\(^{130}\) Note 69 supra.
\(^{131}\) Van Dyke v. Cary, 181 Wis. 564, 191 N.W. 546 (1923) ; Wis. B.T.A. Rule 3.45.
\(^{132}\) Notes 61, 66 and 67 supra.
\(^{135}\) Note 77 supra.
\(^{136}\) Wis. Stat. §§71.03(1) (b) and 71.03(1) (i) (1961).
\(^{137}\) Wis. Stat. §§71.05, 71.046 (1961) ; Wis. B.T.A. Rules 3.36 and 3.37.
\(^{138}\) INT. REV. CODE OF 1954, §613(b).
\(^{139}\) Wis. B.T.A. Rule 3.35.
\(^{140}\) Note 77 supra.
not the property is located in Wisconsin or not. But royalties from patents and copyrights are not in the nature of rent and therefore are always taxable income in Wisconsin. Deductions for depreciation, interest, taxes, etc. can be taken. As under federal law, expenditures which add to the value or useful life of such property are not allowable as expense deductions. They are treated as permanent investments to be added to the cost basis of the property and charged off through depreciation.

D. EXPENSES

Under Wisconsin tax law, a trust is allowed the same deductions for expenses incurred in carrying on a business or in the production of income as an individual. Deductions are allowed the trust for fees and commissions paid to the trustee and all ordinary and necessary expenses of administering the trust. Contrary to federal law, where allocation is mandatory, fees and expenses may not be apportioned or allocated to taxable and non-taxable income, but should be allocated entirely to taxable income.

III. Other Reasons for Maintaining Separate Records

Throughout the discussion of the taxability of the various income and expense items, the necessity of keeping separate records for non-tax trust accounting purposes, federal tax purposes, and Wisconsin tax purposes was pointed out. In many cases the necessity arose because of differing bases for assets as a result of different tax rules regarding depletion, depreciation, amortization, and undistributed capital gains. There are other reasons why the basis of an asset for Wisconsin tax purposes and court accounting purposes may differ from the federal tax basis.

One such reason would be the differing tax laws as to basis of an asset received as a gift. For Wisconsin tax purposes, the basis of the property acquired by gift is the market value at the date of the gift, but for federal tax purposes it is the basis which the donor had.

Another instance would arise if assets were purchased in another state and later brought within the jurisdiction of Wisconsin. The federal tax basis would be the cost at purchase, but for Wisconsin the

141 Note 133 supra.
142 Appeal of Hansen, Wis. B.T.A. (1933), cited in CLARK, supra note 134, at 56.
143 Wis. Stat. §71.05(2), (4) (1961).
144 Note 91 supra.
146 Note 88 supra.
147 Wis. Dept. of Taxation v. Chester, 1 W.B.T.A. 316 (1946).
148 Wis. Stat. §71.03(1)(g) (1961).
149 INT. REV. CODE OF 1954, §1015.
150 INT. REV. CODE OF 1954, §1012; It is assumed that no adjustments of basis under the Internal Revenue Code have been required.
basis would be the market value at the date the asset came within the jurisdiction of Wisconsin.\footnote{Siesel v. Comm., 217 Wis. 661, 259 N.W. 839 (1935), Greene v. Comm., 221 Wis. 531, 266 N.W. 270 (1936).}

If the alternate valuation date was used by an estate for federal estate tax purposes,\footnote{This election is discussed by the writer of Tax Accounting Problems of Personal Representatives, supra note 3. The alternate valuation date is one year subsequent to the date of death, or if the property is sold within one year, the date of its disposition.} the result would be that all or most of the assets would have a different basis for federal income tax purposes than for Wisconsin income tax purposes, since this alternative valuation date has no counterpart under the Wisconsin inheritance tax. In Wisconsin, the basis will be the market value as of the date of the decedent’s death.\footnote{Estate of Benjamin, 235 Wis. 152, 292 N.W. 304 (1940).}

There is one more instance which would result in different tax basis of assets in a trust, but since it would involve a discussion of the complex concepts of “distributable net income” and the federal distributions deduction, it is beyond the scope of this article.

CONCLUSION

In addition to the interpretive problems under the Uniform Principal and Income Act in Wisconsin,\footnote{These interpretative problems are discussed in Trust Accounting, supra note 2.} the bookkeeping problems discussed in this article make it questionable whether, if discretionary allocation by the trustee is desired, it should be limited to areas “where there is no provision made therefor by statute.”\footnote{One of the forms suggested by a Milwaukee trust company gave the trustee a discretionary power to “determine upon allocations, charges or credits as between principal and income where there is no provision made therefor by statute, but regardless of any statute, to charge its customary annual fee to income.”} However, even if the trustee is freed from conforming to the Uniform Act and has discretionary power to allocate and apportion as between income and principal, the problems connected with the differences between Wisconsin and federal tax laws still confront the trustee, making the administration of the trust more complicated for all trustees and impeding plans for cost and time-saving mechanical processing of tax returns by the corporate trustee.